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Via Facsimile (303) 231-3385

Mr. David S. Guzy, Chief
Rules & Publications Staff
Royalty Management Program
Minerals Management Service
Building 85, Denver Federal Center
Denver, Colorado 80225

Re: Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil Supplementary Proposed Rule (62 FR 36030, July 3, 1997)

Dear Mr. Guzy:

Marathon Oil Company ("Marathon") submitted its comments to the Supplementary Proposed Rule via letter dated August 1, 1997.

Marathon stated therein, that as an alternative to MMS' oil valuation proposal, it fully endorses the benchmark system outlined in the comments to the Supplementary Proposed Rule submitted by the Independent Petroleum Association of America ("IPAA"). Enclosed is the *Oil Valuation Benchmark System* referred to in IPAA's comments. Please incorporate this document into Marathon's comments as Exhibit "B".

If you have any questions please contact me.

Sincerely,

Dow L Campbell

Dow L. Campbell

Enclosure

cc: The Office of Information and Regulatory Affairs
Office of Management and Budget
Attention Desk Officer for the Department of the Interior
725 17th Street, N.W.
Washington, D.C. 20503

[81164]

Exhibit "B"

Oil Valuation Benchmark System

IPAA and DPC have proposed that the Minerals Management Service ("MMS") adopt a set of benchmarks which would be used for valuing royalties on non-arm's-length transactions. To make the benchmark system simpler for MMS and lessees to administer, lessees would assume much of the burden of gathering the information needed to determine benchmark values for each field or area. Lessees would be required to keep all records used to determine the proper application of the benchmarks to their transactions to facilitate review by MMS's auditors.

The proposed benchmarks have as their premise that arm's-length transactions in the field or area are the best indicator of fair market value at the lease. Valuation should be based on comparable sales or purchases. Comparability refers to the time the contract was signed, the duration of the contract, the quality of the oil, the location of the leases from which the oil is produced, and the point in the stream of commerce at which the sale occurred. To use obvious examples, sales of Alaska North Slope crude oil or of Louisiana Light Sweet crude oil in the spot market in market centers such as Los Angeles and St. James, Louisiana, are not comparable to sales of Wyoming Sour or San Joaquin Valley Heavy crude oil at the leases where produced under one-year sales contracts.

Each month, a lessee would review its sales or other transactions to determine whether each met the criteria for treatment as arm's-length transactions. Those that do would be governed by the gross proceeds rule, and the lessee's royalty obligation would be satisfied by paying MMS the royalty percentage of its total proceeds from the sale of the oil. Those that do not would be governed by the benchmarks. If a lessee is unable to use any of the benchmarks concerning sales in the lease market, it would use an acceptable netback methodology employing price information from the nearest market center or aggregation point. The netback methodology would be used as a last resort.

A clear understanding of key terms is essential to successful implementation of a benchmark system. The terms "field," "area," "arm's-length contract," and "like-quality" are used in these comments in accordance with MMS's existing definitions in 30 C.F.R. § 206.101.

We understand MMS's view that if an arm's-length contract (or group of contracts) is to be used to value a non-arm's-length transaction, the arm's-length contract (or contracts collectively) must involve "significant quantities" of oil. Reasonable people can disagree over whether the term "significant quantities" should be given a "bright-line" definition or whether its meaning necessarily depends on the context of the transaction to which it is applied. Ultimately, though, the "significant quantities" test is one way of asking whether the given contract reasonably reflects the value the marketplace is putting on that oil. DPC and IPAA recommend that MMS adopt a bright-line test on this issue. An arm's-length contract (or contracts) would involve a "significant quantity" of oil if it (or they collectively) involves at least 10% of the lessee's working interest share of production in the field or area in the given production month.[1]

The first benchmark used by the lessee would be its outright sales of like-quality crude in the field or area. The lessee could bid out a significant quantity of crude oil for sale under its system. Structurally, IPAA and DPC recommend that MMS establish a grid to divide the United States into market areas. These areas would be based on producing basins and pipelines systems, similar to those area determined for natural gas during the negotiated rulemaking process. For example, the State of Wyoming could be divided into three areas: the Powder River Basin, the Bighorn Basin, and the Southwest Basin. Depending on how the lessee offered its oil to third parties, a price or range of prices for crude oil with similar sulfur content and API gravity would be established within each area. If a single price resulted from the bid process, that price would be used for royalty purposes. If a range of prices resulted, the volume-weighted average of the range would be used to value the lessee's crude oil for royalty purposes.

The second benchmark would be a lessee's or its affiliate's arm's-length purchases from producers at the lease in the field or area. If the lessee did not have any arm's-length sales, it could use arm's-length purchases of like-quality crude in the field or area for valuation purposes in the same manner as arm's-length sales were used under the first benchmark.

The third benchmark would be outright sales at arm's length by third parties. Information about another party's arm's-length sales is sometimes available to a lessee through operating agreements or other sources.

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1 In our view, 10 percent is higher than needed to reflect a significant quantity. As shown in Exhibit 2, MMS valued oil from the Midway-Sunset field in California based on only 3% of the oil in the field being sold at arm's-length. And MMS has proposed to treat the NYMEX price as the national starting point for royalty value even though only about 1% of the oil traded is actually delivered. But we offer the higher percentage partly to given MMS greater comfort that the contract reflects a market value and partly because the definition is tied to the lessee's working interest share of production, not to total production from the field. The latter feature is necessary to allow the lessee to apply the benchmark contemporaneously. Most lessees will not have field-wide data at the time they must make their royalty payment for the production month.

If a lessee did not have any arm's-length sales or purchases and had no knowledge of relevant third-party sales, the fourth benchmark would call for value based on prices published by MMS. These prices would be the prices MMS obtained for its crude oil taken in-kind. If MMS had not taken any of its crude in-kind in the field or area, the lessee would base its royalty payments on the fifth benchmark: a netback methodology as discussed earlier and in our prior comments.

DPC and IPAA also propose modifying Form MMS-2014 to collect additional information from lessees on a monthly basis. Specifically, each line of Form MMS-2014 would indicate whether the transaction was arm's-length or not, the quality of crude (such as sweet or sour), and the pricing basis (posting, posting plus, benchmark, index). This information will be essential for MMS to verify via audit the arm's-length transactions used by the lessee in determining the benchmark price in a field or area. Also, MMS would be able to monitor the prices it received on a monthly basis and compare a lessee's benchmark prices to its arm's-length transaction prices and other companies arm's-length and benchmark prices using the information reported on Form MMS-2014. These changes are simple and inexpensive, in contrast to the proposed new Form MMS-4415.

It is our understanding MMS is considering moving from payor-based audits to field/area audits. A benchmark system and field/area audits would complement each other, and, along with additional information reported on Form MMS-2014, would ease the administrative burden faced by MMS and allow it to monitor pricing on a timely basis.

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